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Sarbanes-Oxley
Section 404:
Compliance Challenges
for Foreign Private Issuers

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Sarbanes-Oxley Section 404:

Compliance Challenges for Foreign Private Issuers

Public companies large and small have labored over the requirements of section 404 of the Sarbanes-Oxley Act of 2002 (“the Act”). Especially demanding has been the burden on accelerated filers with international operations. This document summarizes some of the experiences of these accelerated filers and highlights some key challenges that many foreign private issuers (FPIs) will face as part of their section 404 readiness activities.

Requirements of the Act

Companies that meet the accelerated filing requirements of the Securities and Exchange Commission (SEC) (referred to throughout the document as “accelerated filers”) are now finalizing their assessment of internal control over financial reporting, as mandated by the Act. FPIs are required to include in their annual report, beginning with year-ends on or after July 15, 2005, an internal control report from management that contains:

- A statement acknowledging management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any “material weaknesses” in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

Although the SEC has delayed the effective date of section 404 of the Act three times, many accelerated filers have found the effort to be challenging and time-consuming. In fact, numerous companies underestimated the amount of work necessary to document, evaluate, test, remediate, and report on controls. A survey conducted by ACL Services Ltd. and the Center for Continuous Auditing, in July 2004, revealed that only 38 percent of respondents had completed more than 80 percent of their internal control assessment activities. While somewhat dated, this survey illustrates the progress (or lack thereof) that accelerated filers had made with less than six months remaining until the effective date of section 404. As part of their section 404 readiness activities, companies have also identified many internal control deficiencies that required remediation prior to the end of their fiscal year. This observation is supported by the number of internal control deficiency disclosures made by companies as the section 404 compliance date drew near. In *Compliance Week's* December 2004 publication, it was reported that 119 companies disclosed internal control deficiencies during the month of November, compared with 11 companies during the same period in the prior year. *Compliance Week* also reported that the total number of companies making such disclosures in 2004 was 582.

The impact of reporting the existence of a material weakness is still unclear, due to limited research done on the subject. However, some insight is offered from two sources:

In October 2004, Moody's Investors Service released a special report entitled *Section 404 Reports on Internal Control: Impact on Ratings Will Depend on Nature of Material Weaknesses Reported*. In the report, Moody's examined the potential impact that material weaknesses will have on a company's rating. Moody's distinguished between controls over specific account balances (Category A) and company-level controls such as the control environment and the financial reporting process (Category B). In its report, Moody's indicated that it would give companies that disclose Category A material weaknesses “the benefit of the doubt and not take any related rating action, assuming management takes corrective action to address the material weakness in a timely manner.” Moody's, however, stated that Category B material weaknesses “may result in us bringing a company to rating committee to determine whether a rating action

is necessary.” This is due to Moody’s belief that “Category B material weaknesses call into question not only management’s ability to prepare accurate financial reports but also its ability to control the business.”

In January 2005, Fitch Ratings released a similar report entitled *Sarbanes-Oxley 404 — Fitch’s Approach to Evaluating Management and Auditor Assessments of Internal Controls*. In its report, Fitch Ratings went even further to claim that significant deficiencies may play a role in its rating decisions and that it would ask companies about the existence of significant deficiencies. Fitch briefly stated that although “significant deficiencies are not required to be reported on Form 10-K, such control weaknesses should be considered and may have rating implications.” Although neither of these studies were sponsored by the SEC or the Public Company Accounting Oversight Board (PCAOB), they provide interesting insight into the possible implications of a discovered material weakness.

Further research has been done on the impact of material weaknesses on a company’s stock price. During Financial Executives International’s January 2005 conference on section 404, the following observation was made: “Preliminary results of a [Stanford Law School and Cornerstone Research] study of disclosures made by 141 companies that revealed material weaknesses in their internal controls between November 2003 and October 2004, found that companies that gave detailed disclosure regarding the material weakness suffered less of a stock price drop than those that did not give details.”

In addition, a November 3, 2004 article by the *Wall Street Journal* entitled “Grasping Internal Controls,” stated that the correlation of material weakness disclosures to stock price fluctuations has been varied. The article noted that companies generally experienced a 5 percent to 10 percent decrease in their stock prices immediately after disclosing a material weakness.

Accelerated Filer Challenges

As they conduct their section 404 readiness activities, FPIs face several challenges. Applicability of these challenges will vary by company due to the unique business environments and regulation in each country, and each company’s own corporate culture. Companies should consult their local professional advisors to ascertain the impact of these challenges on their section 404 readiness project. Key challenges include:

1. Existence of appropriate audit committees
2. Ineffective financial closing and reporting processes
3. Ability to evaluate controls over service organizations
4. Existence of effective internal audit departments
5. Existence of monitoring controls in complex multiple-location environments
6. Potential shortage of U.S. GAAP competencies
7. Management’s experience in assessing internal control over financial reporting
8. Language considerations
9. Existence of general computer controls
10. Information technology system issues
11. Complexity of assessing internal control in multiple geographical locations
12. Effective fraud prevention programs

Note: The issues identified above do not represent a complete list of all challenges that may lead to a material weakness in internal control over financial reporting.

Relief for Foreign Private Issuers

In a February 7, 2005 SEC press release, Chairman William Donaldson indicated that the SEC is considering a delay in the effective date of section 404 for FPIs. The Chairman said, “The benefits of 404 reports are too important not to do it right. An appropriate delay for these issuers might be desirable if, by waiting for smaller companies to have better guidance and for foreign private issuers to work through conversion to IFRS [International Financial Reporting Standards], it achieves more effective implementation of the internal control reporting requirements. I have asked the staff to consider recommending to the Commission an appropriate delay.”

In the event that the SEC again delays the effective date of section 404, Deloitte highly recommends that FPIs do not change the timing or scope of their section 404 work. This recommendation is supported by the SEC’s Chief Accountant Donald Nicolaisen, who stated in the same press release that “If a delay is provided, these companies should use the time to continue documenting and testing their internal controls. The requirement to report on internal controls will not go away and, if the staff does recommend a delay, we expect that it will be the last time that we do so.”

Key Challenges

1. Existence of appropriate audit committees

PCAOB's *Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (the "Standard") requires the independent auditor to assess the effectiveness of the audit committee's oversight in its evaluation of the control environment (paragraphs 55-59). The following factors should be considered in the assessment of the audit committee:

- Independence of the audit committee members from management
- Clarity with which audit committee responsibilities are articulated and the degree to which they are understood by management and the audit committee
- Interaction of the audit committee with the independent auditor, internal audit, and senior financial executives
- Whether the audit committee raises difficult questions that indicates its understanding of critical accounting policies and judgmental accounting estimates
- Whether the audit committee has been responsive to issues raised by the independent auditor

Paragraph 59 goes on to say that "Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists."

Challenge

Companies operating in certain parts of the world (e.g., Latin America, Asia Pacific, and parts of Europe) may not be required to establish audit committees. Additionally, in certain circumstances even when an audit committee exists, it is often not independent of management, nor does it oversee financial reporting to the extent that is required by the Standard.

For example, in Japan, two types of corporate structures exist within the Japanese Commercial Code: 1) Corporate Auditor System and 2) Company of Committee. Under the Corporate Auditor System, which is the most popular system in Japan, the board of directors and the audit committee are comprised primarily of officers of the company and are not required to be outside directors.

Provisions have been made in the Standard for companies whose legal structure does not require an audit committee, or an audit committee comprised of independent directors. In the case of a company that has no audit committee, the expectations and requirements of the audit

committee included in the Standard would apply to the entire board of directors. The independent auditor would be required to assess the effectiveness of the audit committee, or equivalent body, including whether the audit committee operates independently, even though its members are not independent directors (i.e., independence in spirit, not form).

2. Ineffective financial closing and reporting processes

The Standard requires the independent auditor to evaluate the period-end financial reporting process. As described in paragraph 78 of the Standard, "the period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements." Period-end financial reporting processes (as described in paragraph 76) include:

- The procedures used to initiate, authorize, record, and process journal entries in the general ledger
- Other procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements, such as consolidating adjustments, report combinations, and classifications
- Procedures for drafting annual and quarterly financial statements and related disclosures

Challenge

In certain instances, companies have not designed appropriate controls to address risks associated with the financial reporting process. Certain FPIs may not ordinarily perform a "hard close" for the purposes of their financial statements on a regular basis (i.e., monthly or quarterly). Consequently, significant adjustment types, such as those related to accruals, allowances, deferred items, provisions, impairments, fair value adjustments, and the provision of income taxes, are performed occasionally and, in some circumstances, only at year end. Accordingly, some FPIs may only have one opportunity to demonstrate to the independent auditor that the financial close and reporting process is operating effectively.

In addition, some of these companies maintain their accounts and records in accordance with local Generally Accepted Accounting Principles (GAAP) (e.g., local GAAP or IFRS); and seldom do they use U.S. GAAP as their primary basis of accounting. As a result, the preparation of U.S. GAAP financial statements, including the required disclosures, is principally a compliance exercise for preparing the Form 20-F. In many cases, companies have not designed controls to address risks associated with the financial reporting process. This situation is further complicated in Europe with the first-time implementation of the IFRS in 2005, which will require significant changes and enhancements in the overall financial closing and reporting process.

3. Ability to evaluate controls over service organizations

The Standard requires that if a service organization's services are part of a company's information system (as described in paragraph B19 of the Standard), "then they are part of the information and communication component of the company's internal control over financial reporting," and therefore should be assessed. Both management and the independent auditor should consider the activities of the service organization in determining the evidence required to support his or her assessment of internal control over financial reporting.

Paragraph B21 of the Standard and question 25 of the PCAOB's *Staff Questions & Answers Auditing Internal Control Over Financial Reporting* June 23, 2004 (revised July 27, 2004) state that a "Type II SAS 70" report should be obtained in circumstances where it is not possible to obtain direct evidence supporting the design and operating effectiveness of the controls at the service organization.

SAS 70 Report

A SAS 70 report is derived from the Statement of Auditing Standards No. 70, Service Organizations (SAS 70). A SAS 70 Type I report simply describes the control activities at the service organization. A SAS 70 Type II report includes the coverage of a Type I report, and also tests the operating effectiveness of service organization control activities.

Challenge

Internationally, it is a common business practice to outsource inventory management, pension, payroll, IT services, and in some circumstances, the accounting or bookkeeping function to third parties. Despite the growth of outsourcing, Type II SAS 70 reports are not common. When a report similar to a Type II SAS 70 report (e.g. an AUS 810 report in Australia) exists, the differences and the sufficiency for use as evidence of the design and operating effectiveness of outsourced controls should be carefully considered.

4. Existence of effective internal audit departments

The Standard allows the independent auditor to rely on the work of others (e.g., tests performed by internal auditors, other company personnel, or third parties working under management's direction) in completing their evaluation of management's assessment of the company's internal control over financial reporting. Paragraphs 108 through 126 of the Standard provide guidance about using the work of others to alter the nature, timing, and extent of the work the independent auditor would otherwise have performed and indicate that relevant considerations include the nature of the control tested and the competence and independence of the individual performing the test.

Challenge

In some countries, the internal audit function is primarily focused on operating risks and the internal audit personnel may lack the required competency, knowledge, and experience to effectively evaluate internal control over financial reporting. Some companies don't have a formal internal audit function, let alone one that conducts its work based on a recognized internal control framework. Furthermore, because the internal audit function frequently reports directly to management, rather than to the audit committee (if one exists), the internal auditors may lack objectivity in the performance of their work. Therefore, the independent auditor may not be able to leverage internal audit's testing to support their audit of internal control over financial reporting.

5. Existence of monitoring controls in complex multiple-location environments

As part of its internal control assessment, management is required to evaluate and test the company's monitoring activities (a component of the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)). Management is required to implement appropriate monitoring controls that extends to and includes all relevant control activities which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures, and related financial statement assertions. These monitoring controls should extend to every subsidiary of an organization. Both management and the independent auditor are required to evaluate the design and operating effectiveness of these monitoring controls.

Internal Control Frameworks

It is Deloitte's experience that most companies have adopted the COSO internal control framework to support their assessment of internal control. However, many companies are using the COBIT (Control Objectives for Information and related Technology) framework as a source of controls and control techniques for the information systems management environment.

Challenge

Management is required to monitor all relevant control activities including those control activities that exist at a subsidiary level. This is particularly challenging for large multinational companies that have a decentralized organizational model. Some companies may only receive reporting packages from their subsidiaries which allow the corporate office to consolidate the financial statements on a semi-annual or annual basis. For management to effectively assess the operation of subsidiary level controls, reviews should be performed at a sufficient level of detail at the corporate level and then supplemented by

appropriate levels of monitoring and review at the subsidiary level. In addition, management may consider visiting remote locations (or indirectly visiting the locations by sending a delegated representative such as internal audit or using regular conference calls) or reviewing the evidence of effective design and operation from a central location (which is not always possible or effective). The decision to visit a specific location would ordinarily be influenced by the relative significance of a subsidiary to the company as a whole.

6. Potential shortage of U.S. GAAP competencies

Question 7 of the PCAOB's *Staff Questions & Answers Auditing Internal Control Over Financial Reporting* June 23, 2004 (revised July 27, 2004) highlights management's responsibility for the financial statements and the design of effective controls surrounding the preparation of the financial statements. Specifically, the question states that the results of audit procedures performed by the independent auditor cannot be considered when evaluating whether the company's internal financial statements will be presented fairly in accordance with U.S. GAAP (e.g., if while reviewing a final draft copy of the financial statements the independent auditor identified a misstatement in the notes to the financial statements, the misstatement would ordinarily be required to be assessed as a control deficiency and the magnitude thereof evaluated).

Challenge

FPIs traditionally focus on controls relating to the preparation of their primary GAAP financial statements. These companies often utilize their independent auditors or U.S. GAAP specialists to assist in identifying misstatements in preliminary drafts of the company's financial statements, U.S. GAAP reconciliation, or Form 20-F. In addition, many of the U.S. GAAP skills that do exist are at the corporate level and not present at locations outside of the corporate level.

Management's focus on their primary GAAP and treating the U.S. GAAP reconciliation process as a "once-off" year-end activity is not necessarily an indicator of an ineffective system of control; however, it may indicate that the U.S. GAAP reconciliation (which can include very complex reconciliations such as *SFAS 109 — Accounting for Income Taxes* and *SFAS 133 — Accounting for Derivative Instruments and Hedging Activities*) is not effectively integrated into the company's primary financial reporting process at the corporate and subsidiary level.

Also, as a result of section 404, the yardstick has been moved. It's no longer acceptable to rely on the independent auditors to "fix" financial statement disclosures; companies are required to demonstrate that they have the appropriate expertise themselves. The independent auditor's independence is impaired if they are considered to be a part of the company's system internal control.

7. Management's experience in assessing internal control over financial reporting

Independent auditors are required by the Standard to assess the adequacy of management's process for evaluating internal control over financial reporting and conclude whether the assessment performed by management, the evidence obtained, and the conclusions reached were adequate and appropriate.

Challenge

Before Sarbanes-Oxley management did not require extensive internal control expertise and, therefore, it will be challenging fulfilling its obligation to oversee the assessment of internal control. As noted previously in this document (see challenge #4: *Existence of effective internal audit departments*), internal audit may also lack sufficient experience and knowledge in assessing internal control over financial reporting.

More specifically, the lack of internal control expertise and knowledge outside the U.S. was evidenced in the experiences of many U.S. accelerated filers that required internal control audit procedures to be performed at their international locations. The amount of work required to document, evaluate, and test controls at these international locations was often underestimated. Additional time required to perform these audit procedures can be attributed to:

- The business environment in certain regions (e.g., Asia, Latin America and parts of Europe) may be less focused on controls
- The fundamental understanding of internal control over financial reporting is new to management
- A lack of understanding of the purpose and reason for management's assessment process in the context of the "Standard"

8. Language considerations

Accelerated filers with locations outside of the United States have experienced challenges in addressing language differences. Often, materials provided by the corporate office were in English, while staff documented their work in their native language.

Challenge

Deloitte's experience from section 404 readiness engagements conducted in Latin America and parts of Central Europe indicate that English is not always an effective medium of communication or documentation. Since FPIs often operate in multiple countries with different languages, they may be challenged to identify a language that can be used to effectively communicate the "tone at the top" in a manner that a person on the factory floor will be able to understand.

9. Existence of general computer controls

The Standard (paragraphs 75 through 87) addresses the testing of general computer controls. It states, “the nature and characteristics of a company’s use of information technology in its information system affect the company’s internal control over financial reporting.” General computer controls have a pervasive effect on the effectiveness of the underlying application controls.

According to COSO, general controls, which are designed to ensure that the financial information that is generated from a company’s application systems can be relied upon, include the following types of controls:

- Data center operation controls — controls such as job set-up and scheduling, operator actions, backup and recovery procedures, overall systems availability, and contingency or disaster recovery planning
- System software controls — controls over the effective acquisition, implementation, and maintenance of system software, database management, telecommunications software, security software and utilities
- Access security controls — controls that prevent inappropriate and unauthorized use of the system
- Application system development and maintenance controls — controls over development methodology, which includes system design and implementation, outlining specific phases, documentation requirements, approvals, and checkpoints to control the development or maintenance of the project and version control

For example, access security controls, which comprise the design, implementation and maintenance of information security, is an example of a complex general computer control that should be tested as part of management’s assessment of internal control.

Challenge

Maintaining effective information security controls in less regulated business environments or where there is inadequate segregation of duties can be challenging. For example, in some FPIs access controls are often not designed and implemented.

10. Information technology system issues

The Standard requires companies to test manual and automated process/transaction-level controls (i.e., application controls) over all relevant financial statement assertions (paragraphs 68 through 70). Companies should strive to achieve a balance of these controls that can either be: 1) performed manually by company personnel, 2) performed by

company personnel using IT system reports (i.e., IT dependent controls) or 3) performed automatically by the company’s IT system (i.e., application control).

Challenge

While most FPIs have implemented sophisticated IT systems, there are instances of companies that do not have qualified IT personnel to design and assess application controls within these systems. In addition, some FPIs have highly decentralized legacy financial applications located around the world, which complicates the process of assessing application controls.

11. Complexity of assessing internal control in multiple geographical locations

Appendix B of the Standard provides guidance on determining which geographical locations should be included in the scope of the assessment of internal control over financial reporting. Locations that are required to be included in the scope of the assessment include: 1) locations that are individually important, 2) locations that contain specific risks, and 3) other locations that achieve a large portion of the company’s operations and financial position.

Challenge

Oftentimes, FPIs operate in multiple geographical locations; in addition, a large portion of these locations are outside of the country where the company’s corporate headquarters are located. Based on Deloitte’s insights into the experiences of accelerated filers that have been required to assess internal control in subsidiaries that operate in countries outside of the United States, FPIs will face a significant challenge in conducting their internal control assessment in locations outside of their home country. These challenges include: language differences, lack of U.S. GAAP competencies, non-integrated software packages/systems, and ineffective and/or untimely monitoring of subsidiaries’ internal control and financial reporting.

12. Effective fraud prevention programs

The SEC’s *Final Rule: Management’s Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, provides guidance on management’s responsibilities related to the prevention, identification, and detection of fraud: “The assessment of a company’s internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include...controls related to the prevention, identification, and detection of fraud.” Examples of such controls include:

- Code of ethics/conduct provisions, especially those related to conflicts of interest, related-party transactions, illegal acts, and the

monitoring of the code by management and the audit committee or board

- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit
- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters

Additionally, PCAOB *Auditing Standard No. 2* increased responsibilities for independent auditors beyond those required by the *Statement on Auditing Standards, Consideration of Fraud in a Financial Statement Audit (SAS 99)*. Although SAS 99 provides detailed guidance on the fraud risk assessment, it only requires the independent auditor to gain an understanding of management's antifraud programs and controls. Under PCAOB *Auditing Standard No. 2*, independent auditors should evaluate antifraud programs and controls as part of the audit of internal control over financial reporting. Due to the importance of management's antifraud programs and controls, deficiencies in this area ordinarily constitute at least a significant deficiency in internal control over financial reporting.

Challenge

On occasion, FPIs may have lacked effective fraud prevention programs because they were not required to maintain such programs. Deloitte's insight into the activities of accelerated filers in this area, is that the development of effective antifraud programs was an afterthought for some accelerated filers that were heavily-focused on process and information technology controls.

In some FPIs effective antifraud processes and controls may not exist, and if they do, they generally are not as effective as those required by the Standard. This is prevalent in certain regions where trust is the cornerstone of business.

Summary

Many of the challenges outlined in this document are based on the application of learnings from accelerated filers, which are anticipated to apply equally to FPIs.

A key insight that FPIs should consider is the need to carefully plan and scope all aspects of their section 404 readiness project. It is Deloitte's experience that many accelerated filers did not invest the appropriate amount of time in planning their project. As a result, the costs associated with documenting, evaluating, and testing controls was higher than if a measured and planned approach had been adopted. And because of deficiencies in the planning process, certain companies were unable to remediate material weaknesses or complete their internal control assessment by the end of their fiscal year. Accordingly, FPIs are encouraged to spend the appropriate amount of time planning and scoping their project. Also, although the relevance of the challenges outlined in this document will vary by country and an organization's overall preparedness, FPIs should carefully consider the impact of these challenges in their planning and scoping activities.

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